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THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968

Walter G. Olson*

INTRODUCTION

As this article is being written, California's first Corporate Securities Law is serving out the final year of its 51-year term.¹ The Corporate Securities Law of 1968 is not yet operative² and, of course, has not been exposed to the searching inquiry of everyday practice. It should be recognized that any attempt to analyze the new law at this early date will necessarily be colored, to some extent, by practices and experience under the old law and that the more significant aspects of the new law may emerge gradually over a period of several years.

No one can deny that the old law functioned adequately in the performance of its assigned task of protecting California investors. During those years when it stood alone in providing investor protection, it achieved this protection, for the most part, with reasonable efficiency and without unduly burdening legitimate business processes.

On the other hand, it is equally indisputable that fundamental changes in California's approach to securities regulation were long overdue. A law designed to regulate securities transactions and markets essentially local in character, unassisted by controls at the federal and industry levels, could hardly be expected to function effectively and efficiently when applied to vast interstate securities markets which have been subjected to a major degree of supervision by other regulatory bodies. Moreover, experience has demonstrated that there were major gaps in the old law, particularly in

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¹ California's first blue sky legislation, entitled the "Investment Companies Act," was enacted in 1913. Cal. Stats. 1913, ch. 353, p. 715. In 1917 the "Corporate Securities Act," Cal. Stats. 1917, ch. 532, p. 673, was adopted, and in 1949 this Act, as amended, was renamed the "Corporate Securities Law" and added to the Corporations Code as Division 1 of Title 4. Cal. Stats. 1949, ch. 384, p. 698.

² CAL. CORP. CODE §§ 25000 to -804 (Ch. 88 § 2 Deering 3 Advance Leg. Serv. 1968) (Hereinafter cited as CAL. CORP. CODE § — (new)). All references in this article to the California Corporations Code are to the provisions thereof as adopted or amended effective January 2, 1969. For convenience, provisions of the prior Corporate Securities Law are identified as the "old law," the "former law" or "CAL. CORP. CODE § — (West 1955) (old)."

the areas of secondary trading, broker-dealer regulation and civil remedies.

Thus, with isolated dissents, California's securities administrators, educators and the bar have agreed for some time on the desirability of a new or substantially revised securities law.³ During the last ten years, at least four attempts to obtain major new securities legislation have been made. In 1959 and again in 1961, efforts were directed toward achieving adoption of the Uniform Securities Act, or a modified version of such Act.⁴ These attempts failed, and in 1967, somewhat in desperation, limited amendments to the old Corporate Securities Law were proposed.⁵ The amendment program was abandoned when the new Commissioner of Corporations, Robert H. Volk, appointed a committee to undertake a comprehensive re-evaluation of securities regulation in California. This study culminated in the introduction of the Corporate Securities Law of 1968.

FRAMEWORK OF THE NEW LAW

Before proceeding to an analysis of some of the specific provisions of the new law, it may be helpful to briefly review its overall structure and some of the more important regulatory concepts which underlie its specific provisions.

Structurally, the new law is made up of nine parts appearing in the following order: (i) definitions, (ii) securities qualification (including exemptions and procedures), (iii) licensing and regulation of broker-dealers, agents and investment advisors, (iv) advertising, (v) fraudulent and other prohibited practices, (vi) civil remedies, criminal penalties and enforcement powers of the Commissioner, (vii) administration, (viii) general provisions, and (ix) a temporary extension of the existing curative permit provisions.⁶ This format is quite similar to that of the old law, and, as a whole, the structural members include everything which one would expect to find in a comprehensive state blue sky law.

To anyone who has undertaken the task of clearing a securities offering in a large number of states, the concept of a uniform blue

³ Address by Commissioner Volk, Los Angeles Town Hall, June 13, 1967; Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 CALIF. L. REV. 344, 393 (1946); Note, *The Uniform Securities Act*, 12 STAN. L. REV. 103, 104 (1959).

⁴ A.B. 2531, Cal. Leg., Reg. (Gen.) Sess. (1959); A.B. 1551, Cal. Leg., Reg. (Gen.) Sess. (1961).

⁵ A.B. 100, Cal. Leg., Reg. (Gen.) Sess. (1967).

⁶ CAL. CORP. CODE § 25000 to -804 (new).

sky law is most appealing. It has similar appeal to state securities administrators, who recognize the need for a collective and uniform approach to the major regulatory problems presented by multi-state securities transactions. Despite the obvious advantages of uniformity, the Uniform Securities Act was rejected as a starting point for the development of a new securities law for California. While there may have been several reasons for this decision, the fact that the Uniform Act was a two-time loser in this state undoubtedly played an important role.⁷

The initial step in the formulation of the new law involved the development of major regulatory concepts. In the development of these concepts, as well as the specific language designed to effectuate these concepts, the committee and its principal architect, Professor Harold Marsh, did not hesitate to borrow from the existing Corporate Securities Law, the Uniform Securities Act and the federal securities laws. The major amendments to the Securities Exchange Act of 1934⁸ enacted in 1964,⁹ which both narrowed the gap in the federal regulatory pattern and established an appropriate model for state regulation, were particularly significant factors.

Among the more important regulatory concepts underlying the specific provisions of the new law are the following:¹⁰

1. A modern state securities law must take cognizance of the significant and increasing regulatory effort exerted by other state and federal agencies and by various industry organizations and should be tailored to avoid unnecessary duplication while providing effective controls where needed to supplement such other regulatory effort or fill gaps which are not reached by such effort.¹¹

2. State of incorporation and corporate "domicile" of the issuer have no significance whatsoever in evaluating the potential injury to, and the need for protection of, California investors; accordingly, the discrimination against California-based companies inherent in the old law should be discarded.¹²

⁷ See note 4 *supra* and accompanying text.

⁸ 15 U.S.C. § 78 (1964).

⁹ Securities Acts Amendments of 1964, Pub. L. No. 88-467 (Aug. 20, 1964).

¹⁰ The statement of these concepts, as well as the conclusions with respect to their significance, necessarily represents the opinion and interpretation of the author.

¹¹ "There can be no reasonable doubt that there is a crying need for a more reasonable correlation and harmonizing of federal and state requirements." Dahlquist, *supra* note 3, at 393. This conclusion, expressed in 1946, is equally appropriate today.

¹² Failure of the old law to provide effective controls over secondary trading led to the invention of "pseudo-foreign corporations" and other unfortunate concepts.

3. An effective securities law must reach secondary trading as well as original issues, without imposing undue burdens upon the holder of outstanding securities.

4. In view of the expanded federal controls, and the continuing supervision permitted by regulation of secondary trading, substantial new exemptions from the securities qualification requirements are appropriate, but such exemptions should not apply to the fraud provisions.¹³

5. The "no man's land" under the old law involving changes in rights, preferences and privileges is intolerable and clarification of the situations in which qualification is or is not required is essential.¹⁴

6. The "fair, just and equitable" standard under the old law¹⁵ should be preserved but, at least in the case of securities with an established trading market and issues registered under the federal Securities Act of 1933,¹⁶ the burden of establishing that a particular offering is unfair, unjust and inequitable should be shifted to the Commissioner.

7. A modern securities law should establish clear standards of conduct for the securities industry, with specific remedies (including specific measures of damages) provided wherever these standards are not met.¹⁷

JURISDICTIONAL BASE

In general, the new law reaches, to some degree, all *sales of securities in this state*.¹⁸ Accordingly, the definitions of these terms are extremely important. This is particularly true of the concept "in this state," which, for the first time in California, is given a statutory definition in section 25008 of the new law.

Cf. Sobieski, Securities Regulation in California: Recent Developments, 11 U.C.L.A. L. REV. 1, 13-18 (1963).

¹³ In this connection, experience has demonstrated that the Division of Corporations does little more than shuffle papers in passing upon numerous applications involved, at one end of the spectrum, securities issued by corporations with a very few shareholders, and, at the other, additional issues by corporations whose outstanding securities are widely held and traded on the New York Stock Exchange. *See, e.g.*, Address by Commissioner Volk, Los Angeles Town Hall, June 13, 1967.

¹⁴ *See* Dahlquist, *supra* note 3, at 355-60.

¹⁵ CAL. CORP. CODE § 25507 (West Supp. 1967) (old).

¹⁶ 15 U.S.C. § 77 (1964).

¹⁷ Another conceptual change incorporated in the new law, which is not of great substantive importance but which will be welcomed with open arms by the bar, is the substantial elimination of the negotiating permit procedure. *See* p. 87, *infra*.

¹⁸ Unlike the former law, CAL. CORP. CODE §§ 26103-104 (West Supp. 1967)

In this state

The definition of "in this state" is drawn for the most part from section 414 of the Uniform Securities Act¹⁹ and is designed to provide a broad jurisdictional base for the civil and criminal sanctions contained in the new law. In substance, section 25008 states that an offer to sell or a sale is made in California when (i) the offer originates from California or is directed from another state to California and received at the place to which it is directed, or (ii) acceptance of an offer to buy is communicated to the offeror in California (and this occurs whenever the offeree directs the acceptance to the offeror in California, reasonably believing the offeror to be in California, and such acceptance is received at the place to which it is directed), or (iii) if both seller and purchaser are domiciled in California, the security is delivered to the purchaser in California (i.e., directed to the purchaser in California and received at the place to which it is directed).

Purchases and offers to purchase are deemed made in this state under parallel circumstances.²⁰ Under these definitions, it is obvious that channels of interstate communication cannot be used to avoid the qualification and licensing requirements or the sanctions contained in the new law.

The breadth of this language, however, presents several problems. Absent specific exemptions elsewhere in the law, it sweeps within the qualification and licensing provisions offers originating in California but directed solely to a resident or residents of another state. While it may be appropriate to apply the provisions relating to fraud and prohibited practices to this activity, it seems obvious that California has no valid interest in using its qualification controls to protect nonresidents. In most instances, specific exemptions are available.²¹ Any additional exemptions which may be needed to meet this problem presumably will be provided under the Commissioner's new exemption powers.²²

In some situations, the very nature of our modern communications media makes it impossible to prevent an offer from being received by California residents, even though there is no intent to

(old), the new law includes prohibitions and sanctions applicable to the *purchaser* as well as the seller of a security. *See, e.g.*, CAL. CORP. CODE §§ 25400 to -402 (new).

¹⁹ Uniform Securities Act § 414, 9C U.L.A. (1957).

²⁰ CAL. CORP. CODE § 25008 (new).

²¹ *See, e.g.*, CAL. CORP. CODE §§ 25102(b), (d), 25104(d), (g) (new).

²² CAL. CORP. CODE § 25105 (new). The Commissioner's regulations include an exemption for offers and sales by a licensed broker-dealer to nonresidents where the security is either qualified or exempt from qualification under the laws of the purchaser's residence. 10 CAL. ADM. CODE § 260.105.2.

make an offering in this state. These problems are recognized in subdivision (c) of section 25008, which excludes from the definition of "in this state" a securities advertisement in a newspaper or similar publication²³ which has more than two-thirds of its circulation outside California (as measured by the preceding 12 months' experience) or in a radio or television program originating outside California.

Securities

By this time all lawyers are or should be aware that "securities" may be issued by associations, partnerships, trusts, or even individuals, as well as by corporations,²⁴ and that they may consist of a wide variety of interests or rights.²⁵ Since the decision of the California Supreme Court in *Silver Hills Country Club v. Sobieski*,²⁶ most California practitioners have acknowledged that memberships in a country club may not be sold without a permit of the Commissioner of Corporations if the proceeds are to be used to develop the club's facilities and if a promoter or promoters will derive a profit from the development or operation of the club.²⁷ More recently, the California Attorney General has ruled that a franchise agreement may constitute a "security" if the franchisee provides initial capital needed by the franchisor or if the franchisee participates only nominally in the conduct of the franchised business.²⁸

The definition of "security" in the old law included any "beneficial interest in title to property, profits, or earnings."²⁹ This language is so broad as to be meaningless and has been omitted from the new law.³⁰ While the omission of this language was designed to curb the tendency of some administrators to find anything and

²³ Under the Commissioner's regulations, separate editions of a particular newspaper or magazine will be treated as separate newspapers or magazines to the extent that the advertisement is not carried in all editions. 10 CAL. ADM. CODE § 260.008.

²⁴ See CAL. CORP. CODE § 25003 (West 1954) (old).

²⁵ See CAL. CORP. CODE § 25008 (West 1954) (old).

²⁶ 55 Cal. 2d 811, 361 P.2d 906 (1961).

²⁷ On the other hand, there has been considerable confusion as to the necessity for a permit where no promoters' profits are involved but memberships are being sold to develop a new social or athletic club or to expand the facilities of an existing club. This confusion has been resolved by exempting such memberships. CAL. CORP. CODE § 25100(j) (new).

²⁸ 49 OPS. CAL. ATT'Y GEN. 124 (1967). The Attorney General also ruled that memberships in a nonprofit air travel club which used the proceeds to purchase an aircraft for use of its members constituted "securities." 50 OPS. CAL. ATT'Y GEN. 20, 22-23 (1967). Presumably, air travel clubs will now be treated like any other social clubs and the Attorney General will have to look elsewhere for authority to deal with unsafe aircraft if no promoter is involved.

²⁹ CAL. CORP. CODE § 25008(a) (West 1954) (old).

³⁰ See CAL. CORP. CODE § 25019 (new).

everything to be a "security," there was no intention, by such omission, to reverse the specific holding in *Silver Hills*. To make this clear, the definition of "security" was expanded to include a "membership in an incorporated or unincorporated association."³¹ This change, coupled with the exemption provided for memberships in the usual nonprofit clubs and similar organizations,³² preserves the qualification requirement for a promotional development of the type involved in *Silver Hills*, while relieving most social clubs and other nonprofit organizations of an unnecessary burden and expense.

One other feature of the new definition of "security" deserves special mention. Section 25019 expressly excludes

any insurance or endowment policy or annuity contract under which an insurance company admitted in this state promises to pay a sum of money (whether or not based upon the investment performance of a segregated fund) either in a lump sum or periodically for life or some other specified period.³³

This language, of course, exempts the usual variable annuity as long as it is issued by an insurance company which is admitted in California and therefore subject to the regulatory effort of the California Insurance Commissioner.³⁴

Sale

The definition of "sale" in the new law³⁵ incorporates two important changes. The first relates to the time when jurisdiction attaches to the exercise of warrants, options and conversion privileges. As defined in subdivision (e) of section 25017, an offer or sale of a warrant or right to purchase or subscribe to another security or of a security which is convertible into another security, now or in the future, includes an offer and sale of the other security, but the subsequent exercise of any such purchase, subscription or conversion right is not deemed to involve any offer or sale. Accordingly, the underlying securities must be qualified at the time of issuance of the warrants, rights or convertible securities, and subsequent exercise of any such rights does not require further qualification even though the original qualification may have expired.³⁶

³¹ CAL. CORP. CODE § 25019 (new).

³² CAL. CORP. CODE § 25100(j) (new).

³³ CAL. CORP. CODE § 25019 (new).

³⁴ See CAL. INS. CODE § 827 (West 1955).

³⁵ CAL. CORP. CODE § 25017 (new).

³⁶ Under the old law the issuance of a right pertaining to a security which enabled the holder to subscribe to another security of the same company was not deemed a sale of such other security; however, exercise of the right was considered a sale of such other security within the provisions of the law. CAL. CORP. CODE § 25009(c) (West 1954) (old).

The second change makes the securities law inapplicable to most stock dividends. Subdivision (f) of section 25017 excludes from the term "sale" all common stock dividends payable solely in common stock (except for cash or scrip in lieu of fractional shares) if the corporation has no other class of voting stock outstanding.³⁷

In a recent opinion interpreting provisions of the old law, the Attorney General ruled that various transactions by a security holder which benefit the original issuer of the security constitute a "sale" by the issuer and require a permit.³⁸ Such benefit may take the form of a loan of the proceeds to the issuer, a pledge of the securities to secure a loan to the issuer, or an option granted to induce the optionee to accept employment with or act as underwriter for the issuer. The new law omits the specific statutory language upon which the ruling is rested and, to eliminate any residue of doubt, the new law and the Commissioner's regulations indicate that indirect benefit to the issuer will not give rise to an "issuer transaction" unless the issuer receives some portion of the bargained purchase price, as distinguished from some incidental benefit such as the inducement to become or remain an employee of the issuer.³⁹

EXEMPTIONS FROM QUALIFICATION

Exemptions from the qualification requirements of the new law may be divided into four categories:

1. Exemptions for certain "securities," which apply across the board to sales by the issuer, recapitalizations, reorganizations and non-issuer transactions.
2. Exemptions for certain "transactions" by the issuer, involving securities which are otherwise nonexempt.
3. Exemptions for certain recapitalizations, mergers and other reorganizations involving securities which are otherwise nonexempt.

³⁷ Stock dividends will be distinguished from stock splits in accordance with their usual legal definitions, rather than those applied by the accounting profession. See 10 CAL. ADM. CODE §§ 260.017, -.103.2. "Voting stock" is defined by the Commissioner's regulations to mean stock carrying the present right to vote for the election of directors. 10 CAL. ADM. CODE § 260.017.1. Accordingly, preferred shares which may acquire voting rights upon default in payment of a specified number of quarterly dividends do not constitute "voting stock" until the full number of quarterly dividends are in default.

³⁸ 51 OPS. CAL. ATT'Y GEN. 40 (1968); See also *Bellerue v. Business Files Institute, Inc.*, 61 Cal. 2d 488, 393 P.2d 401 (1964).

³⁹ CAL. CORP. CODE § 25011 (new); 10 CAL. ADM. CODE § 260.011.

4. Exemptions for certain "transactions" when engaged in by persons other than the issuer of the securities involved.

Securities Exemptions

The new law continues to exempt securities issued or guaranteed by the United States, state and local government agencies and instrumentalities, by certain foreign governments and by national and California state banks.⁴⁰ Similarly, securities issued or guaranteed by federal and California savings and loan associations and credit unions, securities issued with the authorization of certain other California administrative agencies (i.e., the Insurance Commissioner, Public Utilities Commission or Real Estate Commissioner), and securities issued or guaranteed by railroads and other common carriers, public utilities and public utility holding companies with the authorization of the Interstate Commerce Commission, the Securities and Exchange Commission or other appropriate federal, state or Canadian agencies are exempt.⁴¹ The exemption for certain life income contracts, which was added in 1967,⁴² is retained in somewhat modified form.⁴³

The new law includes an exemption for commercial paper,⁴⁴ paralleling the related exemptions in the federal Securities Act of 1933⁴⁵ and in the old law.⁴⁶ However, in recognition of potential problems inherent in recent attempts to broaden the market for such paper, commercial paper offered to the public in amounts of less than \$5,000 to any one purchaser are denied the exemption.⁴⁷

Two "securities" exemptions represent substantial changes from the old law and deserve special emphasis. These exemptions cover, respectively, memberships in certain nonprofit organizations and certain listed securities.

As indicated earlier,⁴⁸ memberships in the usual country, ath-

⁴⁰ CAL. CORP. CODE § 25100(a)-(c) (new). Note that subdivision (c) also exempts loan participations issued by one bank to other banks. Query whether this adds anything to the transaction exemption contained in section 25102(i) (new).

⁴¹ CAL. CORP. CODE § 25100(d), (e), (h), (i) (new). As under the old law, CAL. CORP. CODE § 25102(e)(2) (West Supp. 1967) (old), investment contracts involving condominiums and similar real estate developments are not exempt. CAL. CORP. CODE § 25100(f) (new).

⁴² CAL. CORP. CODE § 25100(o) (West Supp. 1967) (old).

⁴³ CAL. CORP. CODE § 25100(k) (new).

⁴⁴ CAL. CORP. CODE § 25100(l) (new).

⁴⁵ Section 3(a)(3), 15 U.S.C. § 77c(a)(3) (1964).

⁴⁶ CAL. CORP. CODE § 25102(b) (West Supp. 1967) (old).

⁴⁷ CAL. CORP. CODE § 25100(l) (new).

⁴⁸ See note 27 *supra* and accompanying text.

letic, luncheon and other social clubs are exempt from qualification under the new law.⁴⁹ This exemption covers proprietary as well as nonproprietary memberships, since it is necessary only that "net earnings" do not inure to members. It is available to a new club offering memberships to finance construction of its facilities, as well as additional memberships sold to finance expansion or improvements, subject only to the limitation that no profits are diverted to private promoters. It is also available to educational, religious, charitable and similar nonprofit organizations. However, debt securities of all such organizations continue to be nonexempt.

Securities listed upon the New York Stock Exchange, or approved for such listing upon notice of issuance, and warrants or rights to subscribe to or purchase securities so listed or approved for listing, are fully exempt from the qualification requirements of the new law.⁵⁰ When contrasted with the similar exemption included in most blue sky laws, this is a fairly narrow exemption. The Uniform Securities Act, for example, also exempts securities listed or approved for listing on the American and Midwest Stock Exchanges and contemplates the possible addition of one or more other regional exchanges.⁵¹ It also exempts securities of senior or substantially equal rank. Thus, debt securities and preferred shares of companies having their common shares listed on any of these exchanges are also exempt in most states.

On the other hand, an exemption of this nature represents a substantial departure from prior California practice,⁵² and it should not be surprising that the committee and the legislature moved cautiously in this area. In singling out the New York Stock Exchange, the committee and the legislature recognized not only the relatively high standards for listing on this exchange but the substantial qualitative requirements for continued listing. It is hoped that this initial step will prove successful and that, in the interest of avoiding duplicative regulation wherever consistent with investor protection, the exemption can be broadened in the future to include other exchanges.

The failure to exempt securities senior to those listed on the

⁴⁹ CAL. CORP. CODE § 25100(j) (new).

⁵⁰ CAL. CORP. CODE § 25100(o) (new). Offers of securities which will be listed when issued, even though not yet formally approved for listing on notice of issuance, are also exempt under the Commissioner's regulations. *See* 10 CAL. ADM. CODE § 260.105.

⁵¹ Uniform Securities Act § 402(a)(8), 9C U.L.A. (1957).

⁵² *See* CAL. CORP. CODE § 25100 (West Supp. 1967) (old).

New York Stock Exchange represents a hold-over of what might be characterized as the *Western Air Lines*⁵³ philosophy. There are some who feel that the stock exchanges either do nothing, or function ineffectively, in supervising the rights and privileges of preferred shareholders, for example, and that continuing oversight of the Commissioner is desirable in this area. While this view is subject to challenge, it is questionable whether the legislature would have accepted an exemption for senior securities at this stage. Again, it is hoped that recognition of the expanded standards and supervision of the exchanges will eliminate any necessity of segmented control at the state level of this aspect of the national securities market.

Issuer Transaction Exemptions

The new law continues the prior exemption for debt securities and partnership interests which are not offered to the public.⁵⁴ The Commissioner's regulations include a partial definition of the term "public offering," providing certain standards which, if met, can be relied upon as establishing the availability of the exemption.⁵⁵ A new, but related, exemption covers offers and sales to banks, savings and loan associations, trust companies, registered investment companies, pension and profit sharing trusts of employers other than the issuer and such other institutional investors as the Commissioner may designate by rule.⁵⁶ This exemption also permits corporations having securities registered under section 12 of the Securities Exchange Act of 1934 to organize direct and indirect wholly owned subsidiaries without qualification of the securities of such subsidiaries. In each case, the purchaser must represent that it is purchasing for investment.

The so-called "small issue" exemption⁵⁷ added by the new law is expected to be of greatest interest to the California bar generally. As in the case of the exemption for listed securities, the "small issue"

⁵³ *Western Air Lines, Inc. v. Schutzbank*, 258 Cal. App. 2d 291, 66 Cal. Rptr. 293 (1968); *Western Air Lines, Inc. v. Sobieski*, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961). Under the *Western Airlines* philosophy the Commissioner is the primary watchdog for rights of minority shareholders.

⁵⁴ Compare CAL. CORP. CODE §§ 25102(e), (f) (new) with CAL. CORP. CODE §§ 25100(l), -102(c), (d) (West Supp. 1967) (old). Note the similar exemption in section 25102(g) of the new law for equipment trusts and other arrangements utilized to finance the acquisition of railroad equipment, vehicles and aircraft.

⁵⁵ 10 CAL. ADM. CODE § 260.102.2.

⁵⁶ CAL. CORP. CODE § 25102(i) (new). The Commissioner's regulations add colleges and universities having endowment funds of at least \$5,000,000, most government agencies and their retirement systems and, subject to certain limitations, corporations having a net worth of at least \$14,000,000. 10 CAL. ADM. CODE § 260.102.10.

⁵⁷ CAL. CORP. CODE § 25102(h) (new).

exemption represents a cautious,⁵⁸ but substantial, step forward in eliminating regulation where it appears to serve no useful purpose.

The "small issue" exemption is available only if *all* of the following conditions are met:

- (a) the issuer is a California corporation,
- (b) having only common stock outstanding,
- (c) which, after giving effect to the proposed sale, is beneficially owned by no more than five persons,⁵⁹ and
- (d) no advertisement is published and no selling expenses are incurred, and
- (e) no promotional consideration is involved, and
- (f) the shares are issued for (i) assets (subject to liabilities) of an existing business transferred to the issuer upon its initial organization, provided the recipients of the shares have owned and operated the business for at least one year prior to the proposed issuance and they divide the shares in the same proportions as their ownership of the business immediately prior to such issuance, or (ii) cash (or cancellation of indebtedness for money borrowed) upon the initial organization of the issuer, provided all shares are issued at the same price,⁶⁰ or (iii) cash following such initial organization, provided the sale is to an existing shareholder or shareholders and is unanimously approved by all shareholders, or (iv) any other legal consideration if there is only one shareholder, and
- (g) the share certificates have been legended in accordance with the Commissioner's rules, and
- (h) the Commissioner is notified of the issuance of shares pursuant to this exemption on a prescribed form signed by all officers and directors of the issuer and the issuees, and

⁵⁸ The Uniform Act, for example, would exempt offers and sales to ten persons during any 12-month period. Uniform Securities Act § 402(b)(9), 9C U.L.A. (1957).

⁵⁹ For this purpose, shares held by a husband and wife are considered to be owned by one person, shares held by a corporation are considered to be held by its shareholders, and shares held by a partnership are considered to be held by the individual partners. CAL. CORP. CODE § 25102(h) (new); 10 CAL. ADM. CODE § 260.-102.5.

⁶⁰ Note that (i) and (ii) cannot be combined, so that new equity money may not be injected by a third party upon incorporation of an existing partnership or proprietorship.

- (i) availability of the exemption is confirmed by an opinion of counsel.⁶¹

The prohibitions relating to selling expenses and promotional consideration would mutilate this exemption, at least for the incorporation of an existing business, if these terms received the traditional broad interpretation of the Commissioner. Accordingly, such terms have been defined quite narrowly for this purpose, in one case by statute and in the other by rule.⁶²

Another change which will be of particular interest to practicing attorneys is the substantial elimination of the negotiating permit. This has been achieved by exempting offers in connection with private placements, including agreements covering such placements which contain certain conditioning language,⁶³ offers of securities being registered under the federal Securities Act of 1933,⁶⁴ negotiations and agreements with underwriters,⁶⁵ and negotiations and agreements relating to recapitalizations and reorganizations preliminary to submission for shareholder approval.⁶⁶ Under the approach taken by the present Commissioner, the negotiating permit should become a curiosity of the past, except, possibly, in isolated instances involving a public offering which is not being registered under the federal Securities Act and which is being made prior to qualification of the actual sale of the securities.⁶⁷

Recapitalizations and Reorganizations

Recapitalizations and reorganizations receive specific and detailed treatment in the new law, and, for the first time, an attempt

⁶¹ CAL. CORP. CODE § 25102(h) (new).

⁶² Under the traditional approach, selling expenses would include such items as printing and mailing costs, and promotional consideration would include any tangible or intangible property to the extent that the value thereof has not been satisfactorily established. See 10 CAL. ADM. CODE §§ 260.140.21, -.140.30; see also 10 CAL. ADM. CODE §§ 349, 368 (old). Clause (4) of section 25102(h) (new) makes it clear that promotional consideration includes only the services of promoters in founding or organizing a business, and the regulations limit "selling expenses" to commissions, discounts and other compensation paid for selling the shares, for purposes of the exemption. 10 CAL. ADM. CODE § 260.102.7.

⁶³ CAL. CORP. CODE § 25102(a) (new). For purposes of this subdivision, an offer to institutional investors described in section 25102(i) (new) and/or to not more than 25 other persons will be considered a nonpublic offering. 10 CAL. ADM. CODE § 260.102.1.

⁶⁴ CAL. CORP. CODE § 25102(b) (new).

⁶⁵ CAL. CORP. CODE § 25102(d) (new). However, the sale must be qualified prior to distribution of the securities in California. *Id.*

⁶⁶ CAL. CORP. CODE § 25103(a) (new).

⁶⁷ See CAL. CORP. CODE § 25102(c) (new). The Commissioner's regulations indicate that a definitive permit will normally be issued even in this situation and that an application for a negotiating permit should be filed only in extraordinary situations. 10 CAL. ADM. CODE § 260.102.

is made to define the situations in which administrative review of proposed recapitalizations is justified. The result will certainly be the elimination of a multitude of applications for negotiating and definitive permits which in the past have involved pure paper-shuffling.

One of the greatest mysteries to an attorney practicing under the old law was the proper time for seeking and obtaining a negotiating permit in connection with a proposed merger or acquisition. If, as many believed, discussions with management of the prospective marriage partner could constitute an "offer," the negotiating permit obviously should be obtained before such discussions commence. Until the past year, however, the Division has been reluctant to issue a blanket negotiating permit before the details of the exchange have been established. As a result, it was necessary to maintain a more or less continuing filing procedure with the Division through the various stages of negotiation, agreement and shareholder submission.⁶⁸ The new law eliminates this foolishness by exempting all negotiations and agreements prior to general solicitation of shareholder approval.⁶⁹ This preserves to the Commissioner the opportunity to review proxy material before it is mailed out to shareholders. It is understood, however, that even in this area the Commissioner does not contemplate the issuance of negotiating permits in most instances. His regulations indicate that a definitive permit should be applied for, and normally will be issued, before distribution of proxy material to shareholders.⁷⁰

Changes in rights, preferences, privileges or restrictions effected after January 2, 1969 will require a permit only if they substantially and adversely affect any class of outstanding securities and only if they fall within one of the categories listed in subdivision (e) of section 25103, in the case of equity securities, or in subdivision (g) in the case of debt securities. The changes so listed all involve significant rights of security holders, such as voting rights, dividend and interest rights or rates, and redemption provisions.⁷¹

The Commissioner's review of stock splits is also reduced by the new law. Qualification is required for a stock split or reverse stock split only (a) if the corporation has more than one class of

⁶⁸ Some attorneys have applied for and obtained two and sometimes three separate negotiating permits for a proposed merger or acquisition.

⁶⁹ CAL. CORP. CODE § 25103(a) (new).

⁷⁰ 10 CAL. ADM. CODE § 260.121.

⁷¹ Authorization or issuance of a new class of preferred stock will no longer be treated as a change in the rights, preferences, privileges or restrictions of or on previously outstanding common shares. 10 CAL. ADM. CODE § 260.103.1. *See also* 10 CAL. ADM. CODE § 260.103, which exempts changes in securities if the original issuance of such securities would then be exempt under section 25102(e)-(g) or (i)-(l) (new).

voting shares outstanding, or (b) publicly traded shares are split to such an extent that their adjusted market price per share is less than \$2, or (c) a reverse split of shares which are not publicly traded would substantially alter the proportionate interests of the shareholders.⁷² This exemption is similar to, but not as broad as, the language excluding most stock dividends from the term "sale."⁷³

As noted earlier,⁷⁴ the new law eliminates any substantial distinction between California or "pseudo-foreign" corporations and other foreign corporations. However, the committee and the legislature recognized that California cannot and should not attempt to pass upon every recapitalization or reorganization simply because one or more California shareholders are affected. Substantial California shareholding obviously should be required, and the new law selects 25 per cent as an appropriate test for this purpose. Thus, a change in rights, preferences, privileges or restrictions does not require a permit if less than 25 per cent of the securities affected substantially and adversely by the change have California addresses.⁷⁵ Similarly, a merger or exchange of securities for assets is exempt if less than 25 per cent of the shares of the merging or selling corporation are held by persons having California addresses.⁷⁶ In each case, addresses are to be determined from the corporate records. Securities known to be held in the names of broker-dealers or their nominees, and securities controlled by any one person who controls one-half or more of all outstanding securities of that class, are not to be considered outstanding.⁷⁷ These exclusions are designed to eliminate the imbalance which would otherwise arise from the disproportionately large holding of "nominee" shares by New York brokers or the majority holding of such controlling persons. As a result, qualification may be required for recapitalizations and reorganizations involving a subsidiary having less than 12½ per cent of its shares held in California.

The selection of 25 per cent was essentially arbitrary. However, it is believed that the major publicly held corporations headquartered outside California have somewhat less than 25 per cent of their shares held of record in this state and that the new law therefore will achieve its objective of not requiring qualification of recapitalizations and reorganizations involving such corporations. It is further believed that California shareholdings of 25 per cent or

⁷² CAL. CORP. CODE § 25103(f) (new).

⁷³ See note 37 *supra* and accompanying text.

⁷⁴ See note 12 *supra* and accompanying text.

⁷⁵ CAL. CORP. CODE § 25103(b) (new).

⁷⁶ CAL. CORP. CODE § 25103(c) (new).

⁷⁷ CAL. CORP. CODE § 25103(d) (new).

more will clearly demonstrate sufficient California contacts to support the requirement of qualification, even for a corporation which transacts no business in this state.⁷⁸

Nonissuer Transaction Exemptions

The nonissuer exemptions include a broad "securities" exemption, covering securities issued by a company which (i) has any of its securities registered under section 12 of the Securities Exchange Act of 1934 (i.e., securities listed on any national exchange or over-the-counter securities registered under section 12(g) of the 1934 Act), (ii) is an insurance company and has securities exempted from registration by section 12(g)(2)(G) of the 1934 Act, or (iii) is an investment company registered under the Investment Company Act of 1940.⁷⁹ It might be more accurate to characterize this as a transaction exemption since it is not available if the offering is being registered under the Securities Act of 1933, or is being made pursuant to Regulation A⁸⁰ under said Act and exceeds \$50,000 in the aggregate.

However, even as so limited, this exemption is very broad and covers most publicly traded securities offered by holders other than "controlling persons," or even by such persons if sold without federal registration in accordance with Rule 154 of the Securities and Exchange Commission.⁸¹

For securities which do not fall within this broad exemption, a specific transaction exemption may be available under section 25104, which covers, among other transactions:

- (a) offers and sales by the owner for his own account, without publication of any advertisement and without utilizing a broker-dealer (except to make a non-public offering);
- (b) offers and sales effected by or through a licensed broker-dealer, provided the order or offer to buy is unsolicited;⁸² and
- (c) offers and sales to certain institutional investors.⁸³

⁷⁸ Cf. *Western Air Lines, Inc. v. Sobieski*, 191 Cal. App. 2d 399, 402, 12 Cal. Rptr. 719, 721 (1961) (where California shareholdings exceeded 30 per cent and the issuer's commercial domicile was in California).

⁷⁹ CAL. CORP. CODE § 25101 (new).

⁸⁰ 17 C.F.R. §§ 230.251 to -.263 (1967).

⁸¹ 17 C.F.R. § 230.154 (1967).

⁸² If a market for the securities exists outside the state, the broker-dealer can contact other broker-dealers who appear, or within the past 60 days have appeared, in the quotation sheets with respect to such securities. See 10 CAL. ADM. CODE § 260.104.

⁸³ See note 56, *supra*.

When any securities are qualified for purposes of an offering by the issuer, nonissuer transactions in securities of the same class are exempt during the ensuing 18 months, and when qualified for purposes of a recapitalization, reorganization or nonissuer transaction, other nonissuer transactions in securities of the same class are exempt during the ensuing 12 months, provided in either case that no stop order is in effect.⁸⁴

The exemptions described above should enable an individual holder to dispose of his securities without any real hardship or loss. For the most part, nonissuer qualification will be essential only for certain public offerings by controlling shareholders as described above and for public trading in securities of companies which are not yet sufficiently large to be subject to registration under section 12 of the 1934 Act.

Exemptions by the Commissioner

The new law seeks to provide maximum flexibility in meeting the problems of private industry, consistent with investor protection. In furtherance of this objective, the Commissioner is empowered to adopt rules exempting other transactions if he finds that qualification of such transactions is not necessary or appropriate in the public interest or for the protection of investors.⁸⁵ This power extends to issuer as well as nonissuer transactions. It should be noted, however, that the statute refers to "transactions" rather than "securities." Presumably, the Commissioner may utilize this power to exempt certain, but not all, transactions in a particular type of securities.⁸⁶

Of equal importance in this area are the provisions of the new law authorizing the Commissioner to issue interpretive opinions and immunizing from liability those who rely in good faith upon such an opinion even though it is subsequently ruled invalid.⁸⁷ While these provisions apply to all parts of the new law, they obviously offer an ideal solution to any question which may arise in determining the applicability of a particular exemption.

⁸⁴ CAL. CORP. CODE § 25104(h) (new).

⁸⁵ CAL. CORP. CODE § 25105 (new).

⁸⁶ The Commissioner's initial regulations include exemptions pursuant to section 25105 for (a) offers of securities which will be exempt under section 25100 at the time of issuance or which will be sold in a transaction exempted by section 25102(i) or section 25104(c); (b) offers and sales to nonresidents as described in note 22, *supra*; (c) nonissuer transactions by or through a licensed broker-dealer prior to May 1, 1969; (d) offers and sales of certain franchises; and (e) certain offers and sales to licensed broker-dealers. 10 CAL. ADM. CODE §§ 260.105 to -105.7.

⁸⁷ CAL. CORP. CODE §§ 25618, -700 (new).

QUALIFICATION PROCEDURES AND STANDARDS

The qualification procedures and standards established by the new law represent an attempt to harmonize the "fair, just and equitable" philosophy of the old law⁸⁸ with the legitimate demands of present-day securities markets. Three different qualification procedures are provided for issuer transactions—coordination, notification and permit. The procedure to be followed in a particular case is dependent primarily upon the nature of the transaction and the nature and marketability of the securities.

Coordination

The procedures for qualification by coordination are designed to accommodate the complex time schedules involved in offerings registered under the federal Securities Act of 1933 and, of course, are available only for such offerings.⁸⁹ The application consists primarily of the registration statement and exhibits filed with the Securities and Exchange Commission and, assuming the required documents and information are filed within the applicable time requirements, California qualification automatically becomes effective concurrently with the effectiveness of the federal registration statement.⁹⁰

Notification

Qualification by notification is provided for securities of certain companies which are already a matter of public record as a result of federal disclosure requirements. More specifically, it is available for (a) securities listed on any securities exchange other than on the New York Stock Exchange,⁹¹ (b) unlisted securities issued by a company having other securities listed on the New York Stock Exchange or any other exchange, (c) over-the-counter securities registered under section 12(g) of the Securities Exchange Act of 1934 or issued by a company having another class of its securities which is so registered, and (d) securities issued by an investment company registered under the Investment Company Act of 1940.⁹² The application must include the information required by the applicable rules and forms prescribed by the Commissioner and

⁸⁸ CAL. CORP. CODE § 25507 (West Supp. 1967) (old).

⁸⁹ CAL. CORP. CODE § 25111 (new).

⁹⁰ *Id.*

⁹¹ Securities listed on the New York Stock Exchange are exempt from qualification. See note 50 *supra* and accompanying text.

⁹² CAL. CORP. CODE § 25112(a) (new).

automatically becomes effective on the tenth business day after the filing is completed.⁹³

Permit

Qualification by permit, i.e., by specific authorization of the Commissioner, is preserved for all other issuer transactions, including all recapitalizations and reorganizations.⁹⁴ It is also available, if the applicant so elects, for securities which may be eligible for qualification by coordination or notification, or for exempt securities,⁹⁵ although such election seems unlikely except in those instances where an exemption from federal registration is sought under section 3(a)(10) of the 1933 Act.⁹⁶ Such qualification becomes effective only when and if a permit is issued.⁹⁷

Nonissuer Transactions

Nonissuer transactions may be qualified by coordination in the case of an offering which is being registered under the federal Securities Act of 1933,⁹⁸ or by notification in the case of other transactions.⁹⁹ An application for qualification may be submitted by the issuer or by a broker-dealer or other person on whose behalf the offering is being made. The information called for by the Commissioner's forms, however, need not be submitted if and to the extent that it is unknown to the applicant or the selling shareholders and cannot be obtained by them without unreasonable effort or expense.

Qualification Standards

The basic qualification standard continues to be "fair, just, and equitable."¹⁰⁰ In the application of this standard, however, two important changes are reflected in the new law.

Under the old law, the Commissioner was authorized to issue a permit only if he found that the proposed plan of business of the applicant and the proposed issuance of securities were fair, just and

⁹³ CAL. CORP. CODE § 25112(b), (c) (new).

⁹⁴ CAL. CORP. CODE §§ 25113, -121 (new).

⁹⁵ CAL. CORP. CODE § 25113 (new).

⁹⁶ Securities Act of 1933 § 3(a)(10), 15 U.S.C. § 77c(a)(10) (1964). Provision for the hearing and approval required by this exemption is made in CAL. CORP. CODE § 25142 (new).

⁹⁷ CAL. CORP. CODE §§ 25113, -122 (new).

⁹⁸ CAL. CORP. CODE § 25111 (new).

⁹⁹ CAL. CORP. CODE § 25131 (new).

¹⁰⁰ CAL. CORP. CODE § 25140 (new).

equitable.¹⁰¹ If the applicant was unable to submit sufficient evidence satisfactory to the Commissioner to support this finding, the Commissioner could and would deny the permit. In other words, the applicant was presumed to be guilty until proven innocent.

As indicated above,¹⁰² qualification by coordination or notification under the new law becomes effective automatically without any affirmative act of the Commissioner. If the Commissioner wishes to deny such effectiveness, or to suspend or revoke such effectiveness after it occurs, he must first find that the proposed plan of business or the proposed issuance or sale of securities is *not* fair, just or equitable.¹⁰³ Thus, the initial burden has been shifted from the applicant to the Commissioner in these instances.

In the case of qualification by permit, the statute no longer *compels* denial of the permit where the Commissioner is unwilling to make an affirmative finding of fairness.¹⁰⁴ He *may* refuse to issue a permit in this situation.¹⁰⁵ While the distinction is subtle, it should discourage refusal to act on an application simply because of some lingering doubt. Any continuing tendency to procrastinate may be met by a demand for a prompt hearing, in accordance with subdivision (b) of section 25143.

The new law includes an express limitation on the power of the Commissioner to pass upon the fairness of price. In the case of public offerings for cash which are registered under the federal Securities Act of 1933 and which are underwritten on a firm commitment basis by an underwriter or underwriters registered under the Securities Exchange Act of 1934, the Commissioner may not deny, suspend or revoke qualification because he considers the offering price to be unfair.¹⁰⁶ This does not affect his power to deny, suspend or revoke for other reasons, including unreasonable promoters' profits or participations.¹⁰⁷

LICENSING PROVISIONS

The provisions of the new law regulating the standards and conduct of the securities industry, and particularly those segments which heretofore have escaped any major degree of supervision,

¹⁰¹ CAL. CORP. CODE § 25507 (West Supp. 1967) (old).

¹⁰² See notes 89 and 93 *supra* and accompanying text.

¹⁰³ CAL. CORP. CODE § 25140(a) (new).

¹⁰⁴ Under the old law the Commissioner was required to deny the permit in such circumstances. CAL. CORP. CODE § 25507 (West Supp. 1967) (old).

¹⁰⁵ CAL. CORP. CODE § 25140(b) (new).

¹⁰⁶ CAL. CORP. CODE § 25140(d) (new).

¹⁰⁷ *Id.*

provide the framework for significant expansion of investor protection in California. Licensing of broker-dealers and agents,¹⁰⁸ of course, is not new in California,¹⁰⁹ but the detailed grounds for denial, suspension, revocation and other disciplinary action are new.¹¹⁰ Also new are the statutory prohibitions relating to manipulative, deceptive and other fraudulent acts, schemes, devices and contrivances,¹¹¹ the financial responsibility requirements,¹¹² the provisions for minimum standards of training, experience and other qualifications,¹¹³ and the requirement of just and equitable business conduct.¹¹⁴

Many of these prohibitions and requirements, of course, are already imposed by the Securities Exchange Act of 1934, the regulations of the Securities and Exchange Commission (S.E.C.), various rules of national securities exchanges, or the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (N.A.S.D.). However, the 1934 Act, the S.E.C. regulations and the stock exchange and N.A.S.D. rules do not apply to all broker-dealers and agents. While the 1964 amendments¹¹⁵ to the 1934 Act extended to all broker-dealers registered under such Act the basic requirements and standards previously imposed upon N.A.S.D. members,¹¹⁶ this still left the broker-dealers who were not so registered, i.e., those engaging exclusively in an intrastate business, free from any real supervision and regulation. The new law closes this gap and imposes upon intrastate broker-dealers in California substantive standards and controls which are essentially equivalent to those applicable to broker-dealers registered with the S.E.C. To avoid duplication, the new requirements are expressly made inapplicable, for the most part, to broker-dealers registered with the S.E.C.¹¹⁷

Similarly, California investment advisers are now subject to state licensing requirements and standards of conduct essentially equivalent to those imposed by the federal Investment Advisers Act

¹⁰⁸ CAL. CORP. CODE § 25210 (new).

¹⁰⁹ See CAL. CORP. CODE § 25700 (West 1955) (old).

¹¹⁰ CAL. CORP. CODE §§ 25212, -213 (new).

¹¹¹ CAL. CORP. CODE § 25216(a) (new).

¹¹² CAL. CORP. CODE § 25216(c) (new).

¹¹³ CAL. CORP. CODE § 25217 (new).

¹¹⁴ CAL. CORP. CODE § 25218 (new). A further expansion of broker-dealer responsibility is found in the provisions relating to advertising. Advertisements published by a licensed broker-dealer which do not relate to a distribution need not be filed with the Commissioner, but such advertisements must be approved by a partner, officer or responsible supervisory official of the broker-dealer. CAL. CORP. CODE §§ 25300, -301 (new).

¹¹⁵ Securities Acts Amendments of 1964, Pub. L. No. 88-467 (Aug. 20, 1964).

¹¹⁶ See note 9 *supra* and accompanying text.

¹¹⁷ See CAL. CORP. CODE §§ 25217, -218 (new).

of 1940.¹¹⁸ Unlike the old law,¹¹⁹ broker-dealers who receive compensation for investment advice are no longer exempted from this licensing requirement.¹²⁰ Moreover, the new law goes beyond the Investment Advisers Act by providing for minimum standards of training, experience and other qualifications, including appropriate examinations. On the other hand, the flat prohibitions against taking a power of attorney and accepting custody of securities or funds from a client, included in the Commissioner's regulations under the old law,¹²¹ have been repealed and replaced by provisions for minimum capital, bonding and other safeguards.¹²²

CIVIL REMEDIES

The civil remedy provisions of the old law consisted essentially of one section to the effect that securities issued without a permit or in nonconformity with a permit were "void."¹²³ For the interpretation of this section and its application to a multitude of specific situations, as well as the development of appropriate remedies and the determination of the applicable period of limitations, the courts were left to grope for solutions under general laws. A more glaring failure to provide legislative guidance for the courts is difficult to find, and it is no wonder that the result has been irremedial chaos for the honest issuer¹²⁴ and frustrating ineffectiveness for the practitioner seeking proper redress for his injured client.¹²⁵

The new law includes specific standards of conduct for those engaging in securities transactions, with specific remedies for violation of these standards and specific time limits within which these remedies must be pursued.

¹¹⁸ Compare 15 U.S.C. § 80b with CAL. CORP. CODE §§ 25230 to -235 (new).

¹¹⁹ See CAL. CORP. CODE § 25007 (West 1955) (old).

¹²⁰ CAL. CORP. CODE § 25009 (new).

¹²¹ 10 CAL. ADM. CODE §§ 732, 733 (old).

¹²² CAL. CORP. CODE §§ 25236, -237 (new); 10 CAL. ADM. CODE §§ 260.236 to -237.1.

¹²³ CAL. CORP. CODE § 26100 (West 1955) (old).

¹²⁴ The courts had no difficulty in concluding that "void" really meant "voidable," but the determination of who could assert invalidity in a given situation, and with what consequence and when, proved to be quite difficult. See *Reed v. Norman*, 41 Cal. 2d 17, 256 P.2d 930 (1953); *Columbia Engineering Co. v. Joiner*, 231 Cal. App. 2d 837, 42 Cal. Rptr. 241 (1965); Note, *Noncomplying Securities in California: Judicial Protection of Interests Under Corporations Code § 26100*, 18 STAN. L. REV. 1184 (1966). Moreover, the issuer which inadvertently found itself with "void" securities outstanding had no clear method of resolving its dilemma, at least until the addition of a statutory curative procedure in 1967. See CAL. CORP. CODE § 25518 (West Supp. 1967) (old).

¹²⁵ The "void" concept had no applicability to securities issued in accordance with a permit, even if fraud were committed.

Failure to Qualify

An issuer or nonissuer selling nonexempt securities without qualification is liable to the immediate purchaser, who may tender back the securities and recover the purchase price plus interest at the legal rate or, if he has disposed of the securities, may recover damages in an amount equal to any excess of his purchase price plus interest over the value of such securities at the time of disposition.¹²⁶ In each case, the recovery is reduced by any income received with respect to the securities by the plaintiff. Suit must be brought within two years after the violation or one year after plaintiff's discovery of the violation, whichever shall first expire.¹²⁷

It will be noted that the new law does not include any concept of "void" or "voidable" securities. Moreover, a purchaser of securities which have not been qualified as required by the law no longer may sit back indefinitely to see whether his investment goes up or down before he decides whether to proceed against the issuer, often to the detriment and injury of other innocent security holders.¹²⁸ The possibility of such detriment to innocent security holders, of course, continues to exist during the new statute of limitations, and to further restrict abuse by the speculating plaintiff, provision is made for cutting off his right of action by a written offer to repurchase, disclosing such right of action and approved as to form by the Commissioner, at a price equivalent to the amount which the plaintiff could recover in a lawsuit.¹²⁹ A period of at least 30 days must be allowed for acceptance of the offer and, if it is not accepted, the right of action is terminated.

A somewhat similar provision lays to rest the so-called "infectious invalidity" doctrine, by eliminating any civil liability based upon an offer to sell or a contract of sale made without qualification, provided qualification is accomplished before payment of the purchase price.¹³⁰ This provision, however, does not insulate the seller from disciplinary or other remedial action by the Commissioner.

While scienter is not required for recovery under section 25503, the language of the first sentence of this section clearly re-

¹²⁶ CAL. CORP. CODE § 25503 (new).

¹²⁷ CAL. CORP. CODE § 25507(a) (new).

¹²⁸ Under the old law, the "void" concept could be asserted against new and innocent management as well as to the detriment of innocent shareholders. "Curative permits" and rescission offers were utilized under the old law in an effort to eliminate the taint on outstanding securities but, at least until the specific statutory authorization of curative permits in 1967, see note 124, *supra*, the effectiveness of these procedures was subject to considerable doubt.

¹²⁹ CAL. CORP. CODE § 25507(b) (new).

¹³⁰ CAL. CORP. CODE § 25503 (new).

quires privity.¹³¹ Subsequent provisions, however, make two exceptions to this requirement. The second sentence of section 25503 indicates that the injection of an underwriter, whether acting as principal or as agent, between the purchaser and seller does not prevent the purchaser from suing the seller.¹³² Similarly, under section 25504, persons controlling the seller, and certain other persons occupying specified positions or relationships with the seller, are jointly and severally liable with the seller, unless they can prove lack of knowledge of the failure to qualify.

Fraudulent Practices

Sections 25400, 25401 and 25402 of the new law create an entirely new area of statutory liability in California. While the conduct proscribed by these sections may, in many instances, violate existing principles of common law or similar provisions of the federal securities laws,¹³³ they provide a significant expansion of the protection and remedies available to California investors.

Section 25400 is addressed to a series of specific activities which are designed to create fictitious market activity in a security. Those activities include certain transactions and activities engaged in for the purpose of creating a false or misleading appearance of market activity and, in the case of broker-dealers and other persons selling or purchasing a security, or offering to do so, any misstatement of or misleading omission to state a material fact for the purpose of inducing the purchase or sale of such security. Liability for violation of this section flows to any and all persons who purchase or sell a security at a price affected by the act or transaction, who may recover damages in amounts equivalent to the difference between the prices at which they purchased or sold and the market value which the security would have had at the time of such purchase or sale in the absence of the violation, plus interest.¹³⁴ Obviously, neither privity nor reliance is required and the potential plaintiffs include everyone who buys or sells the securities affected.

¹³¹ "Any person who violates section 25110, 25120 or 25130 shall be *liable to any person acquiring from him* the security sold in violation of such section . . ." CAL. CORP. CODE § 25503 (new) (emphasis added).

¹³² The purchaser may also sue the underwriter, who is jointly and severally liable with the seller, but the total liability of the underwriter is limited in most instances to the public offering price of the securities underwritten. *Id.*

¹³³ Compare, for example, *Strong v. Repide*, 213 U.S. 419 (1909); Securities Act of 1933 § 17(a), 15 U.S.C. § 77q (1964); Securities Exchange Act of 1934 §§ 9-10, 15 U.S.C. §§ 78i-j (1964); S.E.C. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1967). Liabilities created by the new law, of course, do not supplant liabilities established by federal law or common law. See CAL. CORP. CODE § 25510 (new).

¹³⁴ CAL. CORP. CODE § 25500 (new).

However, liability arises only for *willful* participation in an act or transaction violating section 25400.¹³⁵

Section 25401 makes unlawful any sale, purchase or offer to sell or purchase by means of an untrue statement of a material fact or omission to state a material fact necessary to prevent the statements made from being misleading.¹³⁶ The proscription of this section is considerably broader than the similar provisions of section 25400(d), since no element of willfulness is required. Thus, negligent misrepresentation may violate section 25401. On the other hand, liability for violation of section 25401 extends only to the person who purchases from or sells to the defendant, i.e., to persons in privity with the defendant.¹³⁷ Moreover, to eliminate any inference of absolute liability, section 25501 expressly recognizes the defenses of knowledge by the plaintiff of the untruth or omission and absence of both knowledge and negligence by the defendant. The remedies provided are rescission or damages as appropriate, in each case designed to make the plaintiff whole but not to permit use of the remedy for speculation.

Section 25402 has been widely hailed or criticized as a codification of the *Texas Gulf Sulphur* decision.¹³⁸ It is true that the new law (including section 25402) was drafted after the issuance of the decision of the District Court in *Texas Gulf Sulphur* and while appeals therefrom were pending. However, this section may more accurately be characterized as an effort to meet a broad problem area of which *Texas Gulf Sulphur* is merely one example, and to introduce an element of certainty at the state level to counteract the confusion existing at the federal level.

Section 25402 first delineates the persons to whom it applies: (i) the issuer, (ii) each officer, director and controlling person of the issuer, and (iii) any other person whose relationship to the issuer gives him access to material information concerning the issuer which is not generally available to the public. The prohibited conduct is defined as the *purchase or sale* of any security of the issuer at a time when the insider knows material information about the

¹³⁵ *Id.*

¹³⁶ Total nondisclosure presumably does not violate section 25400 or section 25401. Accordingly, a seller or a purchaser who stands mute cannot be liable under these sections although he may be liable for violation of section 25402.

¹³⁷ CAL. CORP. CODE § 25501 (new). Again, however, controlling and certain related persons may be jointly and severally liable with the violator, under section 25504 of the new law.

¹³⁸ Sec. Exch. Comm'n v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (1966), *modified*, — F.2d — (2d Cir. 1968) (The case involved purchases of Texas Gulf Sulphur stock by officers, directors and others following a major ore discovery in Canada.).

issuer which (a) is not generally available to the public, (b) has been gained from his relationship with the issuer, and (c) would significantly affect the market price of the security. Additional defenses include lack of knowledge that the information is not intended to be available to the public, reasonable belief that the person selling to or buying from him is also in possession of the information,¹³⁹ actual knowledge of such information by the plaintiff, or proof that plaintiff would have purchased or sold at the same price even if the information had been revealed to him.¹⁴⁰

Liability for violation of section 25402 extends only to the person who purchases from or sells to the insider, and damages are limited to the difference between the price at which the plaintiff purchased or sold the security and the market value which the security would then have had if the inside information had been publicly disseminated and absorbed prior to such time, plus interest.¹⁴¹

An action to enforce liability for violation of section 25400, 25401 or 25402 must be brought within four years after the act or transaction constituting the violation, or within one year after plaintiff's discovery of the facts constituting the violation, whichever first expires.¹⁴²

CONCLUSION

The foregoing are the highlights of the Corporate Securities Law of 1968 which are believed to be of general interest. However, there is more, much more, of significance in the new law, and a careful review of all its provisions is a "must" for all California lawyers.

¹³⁹ CAL. CORP. CODE § 25402 (new).

¹⁴⁰ CAL. CORP. CODE § 25502 (new).

¹⁴¹ *Id.*

¹⁴² CAL. CORP. CODE § 25506 (new). An action to enforce a right of indemnification or contribution under Section 25505 must be brought within one year after final judgment for the liability to which such right relates. CAL. CORP. CODE § 25508 (new).